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South Korea: Strong Economy Boosting Chun's Prospects

Summary

South Korean President Chun's political standing was given a big boost by the economy's strong performance in 1983. Broad economic indicators were striking: real GNP grew more than 9 percent, inflation was below 3 percent, and the current account deficit was under \$2 billion. We believe the odds favor continued high growth and low inflation in 1984 and beyond, which will help undercut criticism by Chun's opponents and broaden public acceptance of his government. Nevertheless, fiscal austerity needed to keep the government deficit in line will prevent Seoul from moving as quickly as promised on welfare programs.

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Strong Expansion

Following a 5.6-percent increase in 1982, real GNP grew 9.2 percent in 1983, putting South Korea once again among the world's growth leaders. The high growth was particularly important for Chun because it was the first time his government achieved the type of growth Koreans had become accustomed to during the Park years.

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The industrial sector led the economic advance; industrial output rose about 15 percent in 1983. Gains were broad based with the biggest advances coming in heavy and technology intensive industries. Electronics output, notably color TVs, video tape recorders, and semiconductors grew especially fast. [redacted]

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Domestic demand, which provided most of the stimulus to the economy in the first half of the year, benefited from stable prices. Private consumption rose 7 percent as real wages increased about 8 percent annually in 1982-83 because of the decline in inflation. Consumers stepped up spending especially rapidly on consumer durables such as autos, color TVs, refrigerators, and washing machines. [redacted]

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Private investment increased about 14 percent last year. Lower interest rates sparked an extremely strong increase in construction. Investment in plant and equipment rose briskly because of rising capacity utilization rates, increased profits, and improved business confidence. [redacted]

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Exports powered the economy in the second half of the year. Benefiting from the US recovery, South Korean export volume rose about 15 percent last year. The gains were concentrated in the US and Middle East markets. Seoul achieved big gains in Saudi Arabia and Kuwait with its steel products. Overall, electronics and ships were South Korea's biggest sellers in 1983; shipments of textiles and steel were flat. [redacted]

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Low Inflation

Among the most positive developments in 1983 was the dramatic reduction in inflation. Consumer prices rose 3 percent last year and wholesale prices rose less than 1 percent--the lowest inflation rates ever in South Korea. Tight government policies, a decline in import prices, good grain crops, and slower growth in unit labor costs contributed to the decline. [redacted]

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Reduced Current Account Deficit

Seoul not only achieved high growth with low inflation--a goal few economists thought possible--but also reduced the current account deficit from \$2.6 billion in 1982 to \$1.6 billion last year. The decline in oil prices and the payoff from import substitution efforts held down the growth in imports while exports rose rapidly. In addition, lower international interest

rates benefited the services account. Seoul's economic performance impressed foreign bankers and South Korea had little trouble attracting foreign capital to meet its financing needs.

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Austere Policy Framework

President Chun and his economic advisers can take much of the credit for current economic conditions. The Park government tightened fiscal and monetary policies, curtailed labor cost increases, and slowed private investment plans in 1979 to deal with a seriously overheated economy. The Chun Government strengthened these policies when it came to office in 1980 in order to wring high inflation and inflationary expectations out of the economy and to curtail the growth of the foreign debt. Korean economic planners believed stable prices were a prerequisite for maintaining high growth during the 1980s. Seoul was willing to accept several years of lackluster growth and declining living standards in exchange for low inflation and a manageable balance-of-payments position. Real GNP grew by only 1.7 percent per year during 1980-82, import volume fell 3 percent during the same period, and real wages declined 7 percent during 1980-81.

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The government's policy mix has won praise from the IMF and foreign lenders and put the economy on a sounder footing. Most observers--including international bankers--credit Seoul's policy package for the economy's strong performance.

Austerity remains the watchword for 1984. The growth in the money supply, which was reduced from 28 percent in 1982 to 15 percent in 1983, is targeted at only 12 percent this year. An austere budget has been put in place for 1984 which cuts spending below the 1983 level and reduces the government deficit from 4 percent to 2 percent of GNP. In addition, Seoul has jawboned wage increases down from 24 percent annually in 1978-82 to about 12 percent in 1983 and is hoping to hold the increase to 6 percent this year.

Bright Outlook

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Barring external shocks, we project a strong year for the Korean economy in 1984. South Korea is well positioned to achieve its goal of 7.5-percent real GNP growth. Stronger global demand and a solid competitive position will enable South Korea to maintain rapid export growth in 1984. Exports have strengthened considerably in recent months; in November and December foreign sales were more than 30 percent above year earlier levels. By gradually depreciating the won relative to the dollar and maintaining low inflation, Seoul has bolstered its

competitiveness. We expect Seoul will achieve stronger export growth in Japanese and West European markets this year and continue to score big gains with its increasingly sophisticated electronics products. [redacted]

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Private consumption should increase about 5 percent in 1984 on the strength of rising real wages and employment. The growth in private investment will probably moderate somewhat from the extremely rapid 1983 pace because of tight credit conditions but will remain brisk in response to strong export demand. [redacted]

Government restraint, moderate import price increases, and a good rice harvest should enable Seoul to hold inflation below 5 percent. We expect more rapid price increases in the second half of 1984 as the recovery enters its second year. [redacted]

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The current account deficit, in our judgment, should approximate last year's \$1.6 billion level. Export growth will be strong but imports will pick up as producers rebuild inventories and raw material prices increase. The services' deficit may widen slightly because of a reduction in overseas construction revenue. We believe Seoul has a good chance of attracting foreign funds to cover the red ink; South Korea's credit rating is good and recent syndicated loans have been easily arranged. [redacted]

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Where Things Could Go Wrong

External factors loom as the most significant threat to the South Korean economy in 1984. Growing protectionist tendencies in the developed countries could threaten Korean exporters. An unexpected weakening in global demand or increase in oil prices would be another development which would damage the Korean economy, slowing growth and pushing up inflation. [redacted]

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The greatest threat, however, would be a cutback in private bank lending. South Korea, whose \$40 billion debt is the third largest among developing countries, is vulnerable; about one-third of its foreign debt is short term. Bankers are monitoring South Korea closely, and any one of several events could undermine Seoul's currently strong international credit rating. Political instability in South Korea or a series of terrorist acts by North Korea, for example, could quickly lead to a loss in banker confidence. Under such conditions Seoul would be forced

to impose extremely tough austerity measures that would reduce growth and employment and push up inflation.* [REDACTED]

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Political Implications

Although the rapid economic growth is giving Chun a boost, the government paradoxically is prevented from cashing in fully on this prosperity because of the size of the federal deficit--now 4 percent of GNP--and concerns over rekindling inflation. The austerity measures needed to keep a healthy expansion going limit Chun from delivering on politically attractive programs.

- The tight fiscal position has prevented Seoul from moving as rapidly as promised in implementing welfare-oriented programs. South Korea's Fifth Five Year Plan (1982-1986) was publicized for the high priority it placed on housing, education, medical care, and other social programs. These plans have now been scaled back.
- Reduced government grain subsidies have angered farmers. To slash the budget deficit, Seoul has picked farm subsidies for major reform. Farmers will receive no increase in prices paid by the government for their rice this year.
- Tight credit conditions in the second half of the year have also generated criticism from the business community. Businessman in Pusan and Taegu have been especially gloomy because of the shortage of funds.

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In addition to the austerity program, two major financial scandals--one of which was rumored to involve relatives of the President--tarnished Chun's image. The scandals underscored the weaknesses of South Korea's banking system and Seoul's inability to reform it. [REDACTED]

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Nonetheless, we believe that the strong performance of the South Korean economy has significantly strengthened Chun's ability to build popular support and political stability. Most Koreans continue to rank improvements in their living standards as an important priority--more important than greater political participation--and exceeded only by national security in order of

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priority. Continued high growth, low inflation, and increases in real incomes in the coming year appear likely to further consolidate Chun's position among most Koreans and help contain dissident activity.

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SUBJECT: South Korea: Strong Economy Boosting Chun's
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